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Nos. 476, 477, and 478

In the Supreme Court of the United States

OCTOBER TERM, 1932

D. B. HEINER, COLLECTOR OF INTERNAL REVENUE FOR THE TWENTY-THIRD DISTRICT OF PENNSYLVANIA, PETITIONER

v.

DIAMOND ALKALI COMPANY, A CORPORATION

C. G. LEWELLYN, FORMERLY COLLECTOR OF INTERNAL REVENUE FOR THE TWENTY-THIRD DISTRICT OF PENNSYLVANIA, PETITIONER

v.

DIAMOND ALKALI COMPANY, A CORPORATION

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONERS

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OPINIONS BELOW

The findings of fact and conclusions of law of the District Court in Nos. 476 and 477 (R. 81–91) are

reported in 39 F. (2d) 645. That Court's findings of fact and conclusions of law in No. 478 (R. 27–34) are not reported.[1] The original opinion of the Circuit Court of Appeals (Nos. 476 and 477, R. 106–116) and its opinion on rehearing (Nos. 476 and 477, R. 125–129) are reported in 60 F. (2d) 505.[2]

JURISDICTION

The judgments of the Circuit Court of Appeals were entered July 26, 1932. (Nos. 476 and 477, R. 129, 130; No. 478, R. 62.) Petition for writs of certiorari was filed October 26, 1932, and writs were granted December 5, 1932. (Nos. 476 and 477, R. 133; No. 478, R. 65.) Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

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[1] The *Heiner case*, Nos. 476 and 477 (No. 4419 and 4426 in the Circuit Court of Appeals), relates to respondent's taxes for 1918. In that case two judgments, in identical terms, were entered by the court below, one disposing of the taxpayer's appeal, and the other disposing of the cross-appeal of the Collector. The *Lewellyn case*, No. 478 (No. 4427 in the Circuit Court of Appeals), relates to taxes for 1919.

The *Heiner case* in the courts below also involved taxes for 1920. The allowance by the Circuit Court of Appeals of additional amortization deductions for 1918 and 1919 will operate to reduce respondent's invested capital for 1920 and will thus affect the amount of the 1920 taxes. This matter, of course, may be adjusted upon the return of the case to the District Court.

[2] By stipulation of the parties there has been omitted from the printed record in this Court portions of the record in the court below which dealt with issues not here presented.

QUESTION PRESENTED

The Commissioner determined respondent's profits taxes for 1918 and 1919 by special assessments under Sections 327 and 328 of the Revenue Act of 1918. Upon suits for refund against the Collector, the District Court and the Circuit Court of Appeals upon appeal allowed respondent certain additional deductions from gross income, the effect of which was correspondingly to reduce the amount of the respondent's net income for each of the years 1918 and 1919. The questions here presented are:

(1) Whether the courts below had the power to set aside and review the Commissioner's determination of the amount of *profits taxes* due from respondent.

(2) If so, whether the courts below had the power to redetermine such taxes by applying to the reduced net income the ratios of tax to net income previously used by the Commissioner in his special assessments.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in Appendix A, pp. 35–40, *infra*.

STATEMENT

The respondent duly filed income and profits tax returns for the years 1918 and 1919 and paid the income and profits taxes due as disclosed by these returns in the respective amounts of $1,074,749.11

and $711,392.02. Thereafter the respondent filed with the Commissioner an application for the computation of its 1918 profits taxes under Sections 327 and 328 of the Revenue Act of 1918.[3] (Nos. 476 and 477, R. 89.) The Commissioner granted this application, having found that the respondent's excess profits tax for 1918 as determined without the benefit of Section 327 of the Revenue Act of 1918 would, owing to abnormal conditions affecting capital or income, work upon the respondent an exceptional hardship, evidenced by gross disproportion between the tax computed without the benefit of Section 327 and the tax computed by reference to the representative corporations specified in Section 328 of the Revenue Act of 1918. (Nos. 476 and 477, R. 89.)

In computing respondent's profits tax for 1918 under Section 328 the Commissioner determined the ratio of tax to net income at 54.54 per cent, arriving at that ratio, as he claimed, on the basis of the ratio of average tax to average net income of representative corporations engaged in a like or

[3] On December 23, 1925, the Commissioner advised the respondent that before its application could be granted there must be "a final determination of your tax liability computed on the basis of statutory invested capital," and granted the respondent thirty days in which to protest "against the determination of your net income and statutory invested capital as shown in the attached statement." It does not appear that such a protest was filed. But see footnote 13, p. 17, *infra*.

similar trade or business. (Nos. 476 and 477, R. 89.) By this computation the Commissioner determined, upon a net income found by him to be $3,821,143.63, a profits tax of $2,084,324.26 and an income tax of $206,039.99, a total tax liability of $2,290,364.25 (Nos. 476 and 477, R. 69–76), whereas a computation of respondent's taxes under Section 301 of the Revenue Act of 1918, i. e., without special assessment, upon a net income of $3,785,355.05 had indicated a profits tax of $2,592,789.30, and an income tax of $140,729.65, a total tax liability of $2,733,518.85. (Nos. 476 and 477, R. 80.)

On application by the respondent the Commissioner also granted special assessment for 1919[4] and computed the profits tax for that year by a like method (Nos. 476 and 477, R. 71), finding a ratio of tax to net income of 18.31 per cent (No. 478, R. 33). By this computation the Commissioner determined for 1919, upon a net income of $2,708,248.07, a profits tax of $495,871.87 and an income tax of $214,039.51, a total tax of $709,911.38 (Nos. 476 and 477, R. 72), whereas a computation without special assessment had indicated a profits tax of $709,926.02 and an income tax of $192,634.09, a total tax of $902,560.11. (Nos. 476 and 477, R. 64.)

The taxes as determined by the Commissioner were paid (Nos. 476 and 477, R. 83) but the respondent filed claims for refund of a portion

[4] The application for 1919 was at first denied. (Nos. 476 and 477, R. 62.)

thereof,[5] which claims were rejected by the Commissioner (Nos. 476 and 477, R. 89). Thereafter the instant suits were instituted by the respondent. Jury trials were waived in writing. (Nos. 476 and 477, R. 52; No. 478, R. 28.)

The respondent contended in the District Court that its net income for 1918 and 1919 had been overstated by the Commissioner because of his failure to allow certain deductions for amortization and depreciation. (Nos. 476 and 478, R. 3–4.) Respondent further contended that the Commissioner had erred in the application of Section 328 of the Revenue Act of 1918 to its taxes for 1918 by determining the ratio of profits tax to net income to be 54.54 per cent when, as respondent contended, it should have been 45 per cent. (Nos. 476 and 477, R. 7.) It was neither alleged nor proved that the Commissioner acted fraudulently or arbitrarily in determining the profits taxes for 1918 and 1919 under Sections 327 and 328.

The District Court allowed additional deductions from gross income of $238,001.09 for 1918 and $49,525.73 for 1919, and thereupon recomputed the profits taxes for each of these years by applying to the reduced income the ratios of 54.54% and 18.31%, respectively, which had been used by the

[5] The claim as to 1918, which is the only one appearing in the record (Nos. 476 and 477, R. 57–59), was predicated partly upon the ground that the Commissioner had erroneously failed to allow respondent certain deductions from gross income.

Commissioner upon the net income as computed by him at the time of his determination of the taxes by special assessment. (Nos. 476 and 477, R. 90; No. 478, R. 33.) Cross appeals were taken from the decision of the District Court with respect to the year 1918, and the Collector appealed from the judgment for 1919.

In its original opinion the Circuit Court of Appeals held that the respondent was entitled to still further deductions from gross income, increasing the additional deductions allowed by the District Court by $236,229.18 for 1918 and by $55,045.70 for 1919.[6] In its opinion on reargument the court further increased the deductions for 1918 by granting an additional depreciation allowance of $55,503.06.[7] (Nos. 476 and 477, R. 128.)

In its original opinion the Circuit Court of Appeals held that the District Court was in error in

[6] While the allowance of an increased deduction for 1919 was not relied upon by the petitioners as a reason for granting certiorari, the action of the Circuit Court of Appeals in this respect was clearly erroneous since the taxpayer did not appeal from the judgment of the District Court for that year.

[7] The additional deductions allowed by the Courts below were as follows:

Year	Allowed by District Court	Allowed by Circuit Court of Appeals	Total additional deduction
1918	$238,001.09	$291,732.24	$529,733.33
1919	49,525.73	55,045.70	104,571.43

redetermining the amounts of the excess profits taxes fixed by the Commissioner and held that the respondent was entitled to a refund only with respect to its income taxes. (Nos. 176 and 177, R. 115-116.) Upon reargument the court held, Judge Thompson dissenting, that the respective rates (ratios) fixed by the Commissioner under Section 328 should be applied to the reduced net income for the years in question in computing the profits taxes for those years. (Nos. 176 and 177, R. 125-127.)

SPECIFICATIONS OF ERROR

The Circuit Court of Appeals erred

1. In undertaking to review the Commissioner's determination of respondent's profits taxes.

2. In holding that its applying the ratio determined by the Commissioner under the special assessment provisions of the statute to a reduced net income fixed by the court, for the purpose of computing respondent's profits taxes, did not constitute a usurpation of the discretionary functions confided to the Commissioner by Sections 327 and 328 of the Revenue Act of 1918.

3. In holding that the so called "rates of tax" computed by the Commissioner under Section 328 should be applied to the reduced net income in computing respondent's profits taxes.

4. In affirming the judgment of the District Court with reference to the issue of special assessment.

SUMMARY OF ARGUMENT

I

The courts below were without authority to review and set aside the Commissioner's determination to levy special assessment of respondent's profits taxes. The considerations which determine the right to receive special assessment under Section 327 (d) of the Revenue Act of 1918 "and those which govern the computation in all cases" are the ordinary functions of the Commissioner, and the courts may not review his exercise of those functions in the absence of fraud or like irregularity.

In the instant case there is no allegation or proof of fraud, and no "irregularity" is suggested other than that the Commissioner's computations of the taxes were predicated upon the mistaken finding that respondent's net income was greater than it actually was. The failure of the Commissioner to allow certain deductions from gross income was a mere error with respect to the propriety of the deductions and did not represent such essentially arbitrary action on his part as would warrant a judicial review of the special assessments.

Having elected to seek relief in the courts, the respondent has necessarily precluded a review of those portions of the Commissioner's determination which do not present justiciable questions.

Assuming that the courts below possessed authority to review and set aside the Commissioner's determination of the profits taxes by special assessment, they were without authority to recompute the taxes by applying to the reduced net income the ratios of tax used by the Commissioner in connection with a greater net income. Such ratios were found by comparison of respondent with representative corporations similarly situated "with respect to gross income, net income, profits per unit of business transacted * * * and all other relevant facts and circumstances." The amount of respondent's net income was necessarily a basic factor in the selection of the comparative corporations. Because of the substantial alteration of such basic factor it is impossible to know whether the respondent still was entitled to special assessment, and, if so, what the correct ratios of tax to income should be. Moreover, neither the granting of a new special assessment nor the recomputation of the taxes could be made without performance of the preliminary tasks required of the Commissioner by the statute. In computing new special assessments without the performance of such preliminary tasks, the court below not only exceeded its authority but it necessarily made erroneous determinations.

Assuming that respondent's profits taxes might be redetermined by the courts below, the power of the courts was limited to a redetermination of such taxes *without special assessment*, i. e., under Section 301 of the statute. In the instant cases there was no room for the operation of this limited jurisdiction since the respondent conceded in the court below that its profits taxes as computed on its reduced net income without special assessment would be greater in amount than the taxes as computed by the Commissioner.

ARGUMENT

I

THE COURTS BELOW WERE WITHOUT AUTHORITY TO REVIEW AND SET ASIDE THE COMMISSIONER'S DETERMINATION BY SPECIAL ASSESSMENT OF RESPONDENT'S PROFITS TAXES IN THE ABSENCE OF FRAUD OR LIKE IRREGULARITY

The petitioners contend that the action of the Circuit Court of Appeals in setting aside the Commissioner's determination of respondent's profit taxes and in redetermining such taxes constituted a review of the Commissioner's determination which was unauthorized by the statute and beyond the power of the court. They contend further that in recomputing the profits taxes, by applying to the reduced net income the ratios determined by the Commissioner upon a different net income, the court below *made new special assessments*, and

thus usurped discretionary functions entrusted to the Commissioner.[8]

It is definitely settled that both the determination whether special assessment shall be accorded a taxpayer[9] under Sections 327 and 328 of the Revenue Act of 1918 and the computation of the tax by special assessment[10] are matters within the discretionary powers of the Commissioner, and that

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[8] Petitioners do not question here the action of the courts below in reducing the *normal income tax* by increasing the deductions from gross income and applying to the reduced net income the normal tax rate prescribed by the statute. The questions presented to this Court in the instant cases relate only to the *profits taxes*. Attention, however, is called to the fact that there is a necessary correlation between the profits tax and the income tax since, under Sec. 236 (b) of the statute, the amount of the former is allowed as a credit against net income in computing the latter.

[9] *Williamsport Wire Rope Co.* v. *United States*, 277 U. S. 551, *supra; Duquesne Steel Foundry Co.* v. *Commissioner*, 41 F. (2d) 995 (C. C. A. 3d), affirmed *per curiam*, 283 U. S. 799; *Enameled Metals Co.* v. *Commissioner*, 42 F. (2d) 213 (C. C. A. 3rd), affirmed *per curiam*, 283 U. S. 799. See *Oak Worsted Mills* v. *United States*, 38 F. (2d) 699 (C. Cls.), affirmed on other grounds, 282 U. S. 409; *Standard Rice Co.* v. *Commissioner*, 41 F. (2d) 481 (C. C. A. 5th); *Cramer & King Co.* v. *Commissioner*, 41 F. (2d) 24 (C. C. A. 3d); *Kekaha Sugar Co.* v. *Burnet*, 50 F. (2d) 322 (App. D. C.); *Railroad Supply Co.* v. *Burnet*, 51 F. (2d) 437 (App. D. C.). See also *United States* v. *Henry Prentiss & Co., Inc.*, No. 234, present term, decided January 9, 1933.

[10] *Brown's "Shamrock" Linens* v. *Bowers*, 48 F. (2d) 103 (C. C. A. 2d), certiorari denied, 283 U. S. 865; *Chicago Frog & Switch Co.* v. *United States*, 67 C. Cls. 662, certiorari denied, 280 U. S. 579. In the *Brown's "Shamrock" Linens* case the taxpayer was a foreign corporation and as such was automatically entitled to special assessment.

the courts may not review his exercise of these functions in the absence of fraud or like irregularity.

In *Williamsport Wire Rope Co.* v. *United States*, 277 U. S. 551, *supra*, the Court said (pp. 558–559, 560, 562):

> The task imposed on the Commissioner by §§ 327 and 328 was one that could only be performed by an official or a body having wide knowledge and experience with the class of problems concerned. For the requirement of a special assessment under paragraph (d) of § 327 *and its computation in all cases*, are dependent on "the average tax of representative corporations engaged in a like or similar trade or business."
>
> To perform that task, power discretionary in character was necessarily conferred. Whether, as provided in paragraph (d) of § 327, there are "abnormal conditions;" whether there would be "gross disproportion" between the tax computed under § 301 and "that computed by reference to the representative corporations specified in section 328;" what are "representative corporations engaged in a like or similar trade or business;" which corporations are "as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances"—these

> are all questions of administrative discretion.
>
> * * * * *
>
> Thus the aims which induced Congress to enact §§ 327 and 328, the nature of the task which it confided to the Commissioner, the methods of procedure prescribed, and the language employed to express the conditions under which the special assessment is required, *all negative the right to a review of his determination by a court.*
>
> * * * * *
>
> We conclude that the determination whether the taxpayer is entitled to the special assessment was confided by Congress to the Commissioner, and could not, under the Revenue Act of 1918, be challenged in the courts—at least in the absence of fraud or other irregularities. (Italics ours.)

The *Williamsport case* and other cases above cited leave no room for doubt that the question whether respondent was entitled to special assessment under Section 327 (d) and the computation of the tax under Section 328 were matters which were beyond the jurisdiction of the courts below to review—"at least in the absence of fraud or other irregularities." In the instant cases there is no allegation or proof of fraud, and no irregularity is here suggested other than that the Commissioner's computation of the tax was predicated upon the mistaken finding that respondent's net

income was greater than it actually was. The courts have consistently recognized that the words "fraud or other irregularities" as used in the *Williamsport case* import action on the part of the Commissioner which is essentially arbitrary or which involves a clear abuse of discretion. Mere error on his part is not sufficient. *Live Stock Nat. Bank* v. *United States,* 36 F. (2d) 334 (C. C. A. 8th); *National Bank of Commerce* v. *United States,* 39 F. (2d) 434 (C. C. A. 9th). Obviously the fact that the Circuit Court of Appeals allowed respondent additional deductions from gross income does not demonstrate that the Commissioner's special assessments were fraudulent or arbitrary.

In its brief in opposition to the petition for certiorari, the respondent argued that the result contended for by the Government is unjust, and that its necessary effect is to make the Commissioner the sole judge as to what constitutes income and what deductions a taxpayer may take.[11] This argument is predicated upon the assumption that if the Commissioner had been aware of respondent's

[11] In its brief in opposition respondent says (pp. 9–10): "Carried to its logical conclusion the petitioners' contention means that if the court had found that the Diamond Alkali Company had, for example, only $1,000,000 of net income or even none, the profits tax must remain at more than $2,000,000."

We think the conclusion thus imputed to petitioners is neither logical nor the one to which their contention leads. The words "other irregularities" as used in the *Williamsport case* were intended to have some operation, and the

correct net income he would still have found that it was entitled to special assessment for the years in question, and on the further assumption that the taxes as computed on the reduced net income would be less than the taxes as originally computed by the Commissioner. But these assumptions are not well founded. The reduction of respondent's net income in a substantial amount might well have eliminated the need for special assessment, or required the selection of new comparative corporations for the purpose of determining that need, or resulted in the selection of comparatives having a higher ratio of tax to net income.

The Commissioner computed the profits taxes by special assessment only because respondent requested it. A condition precedent to the computation of profits taxes by special assessment is the prior determination of the taxpayer's net income; otherwise the application for special assessment would be wholly academic, and no such assessment could be made. Accordingly, neither the necessity for special assessment nor the amount of the tax can be determined, with final effect upon the tax liability, except where the parties are agreed upon

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determination and assessment by the Commissioner of a profits tax in excess of the taxpayer's net income might well present a result so unjust and extreme as to require the judicial review otherwise denied. The instant cases present no such situation. Indeed, respondent conceded in the court below that its profits taxes, as computed by the Commissioner, are less than such taxes would be if computed without special assessment on its net income *as reduced* by the courts below. (See p. 31, *infra*.)

the amount of the net income.[12] Taxpayer's obtaining special assessment is wholly inconsistent with its later effort to have its net income reduced.[13] As this Court recently pointed out with respect to the statute here involved in *United States* v. *Henry Prentiss & Co., Inc.*, No. 234, present term, decided January 9, 1933:

> The presentation of such a claim [for special assessment], unlike the presentation of a claim of error in fact or law, does not suggest the need for a new and general audit of assets and liabilities. The two proceed-

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[12] In special assessment cases it is customary, as was done in this case (Nos. 476 and 477, R. 75–76), to request an acquiescence by the taxpayer in the amount of income and invested capital. See *United States* v. *Henry Prentiss & Co., Inc., supra.*

[13] By its letter of December 23, 1925 (Nos. 476 and 477, R. 75–80), the Bureau advised the respondent that its request for special assessment for 1918 could not be considered until final determination of its tax liability computed on the basis of invested capital, and the respondent was given 30 days to protest against the Commissioner's determination of net income (Nos. 476 and 477, R. 76) and invested capital. The record does not disclose that such a protest was made. It does appear that thereafter, by his letter of March 19, 1927, the Commissioner changed his determination of respondent's 1918 net income by *increasing* it. (Nos. 476 and 477, R. 61.) The respondent apparently filed a protest against this determination (Nos. 476 and 477, R. 70) which was overruled by the Commissioner's final letter of July 11, 1927 (Nos. 476 and 477, R. 69–73). This was the final determination of the Commissioner from which taxpayer was entitled to appeal to the Board of Tax Appeals. Substantially the same steps seem to have been followed by both respondent and the Commissioner with respect to the 1919 taxes. (Nos. 476 and 477, R. 60, 69.)

> ings, alike in form and in consequences, *are essentially diverse* * * *. The grievances differ so essentially that the assertion of *the one must be felt to be unrelated to any complaint* as to the other. (Italics ours.)

Substantially the same idea was expressed in a manner specifically applicable to the instant cases in *Cleveland Automobile Company* v. *United States* (N. D. Ohio), decided February 24, 1932, not reported officially, where the court said (Prentice-Hall Federal Tax Service, 1932, Vol. 1, p. 897, 900):

> In this action it [the taxpayer] seeks to have the Court reduce its income and redetermine its profits tax liability computed under special assessment on the basis of the reduced income. * * * If the net income determination never is to become final until the taxpayer is satisfied with the resulting tax liability, the nature and aims of the relief provided by Sections 327 and 328 * * * are to no purpose.

The relief sought under Section 327 (d) differs widely in its form and method of determination from the normal statutory method of computing profits taxes. In one application is addressed to the discretionary judgment of an administrative official, while the other is controlled by the terms of the statute. The remedy in one case is administrative; in the other a justiciable question is presented. We think it was incumbent upon the

respondent, in view of the inherent differences between special assessment and the normal computation of profits taxes, to elect the path it would follow. From the very nature of special assessment and the inability of the courts to control or review the administrative determination, when the taxpayer appeals to the judicial branch he abandons the right further to contest the validity of the administrative determination made at his request. The election is unavoidable because the taxpayer cannot raise a nonjusticiable question in a judicial proceeding. See *Cleveland Automobile Co.* v. *United States* (N. D. Ohio), decided February 24, 1932, *supra*.

We submit that the courts below erred in reviewing and setting aside the Commissioner's determination of respondent's profits taxes.

II

THE COURTS BELOW WERE WITHOUT AUTHORITY TO REDETERMINE RESPONDENT'S PROFITS TAXES BY APPLYING TO THE REDUCED NET INCOME THE SPECIAL ASSESSMENT RATIOS DETERMINED BY THE COMMISSIONER

It does not follow that because respondent's net income was reduced the profits taxes as determined by the Commissioner exceeded the amounts properly due on the reduced net income. (See pp. 15–16, *supra*; pp. 22–25, *infra*.) But even if it be held that, since the Commissioner's special assessments were based upon net incomes in excess of those fixed by the courts below, the respondent's

profits taxes as well as its normal income taxes must be redetermined, the courts below lacked the power to recompute the profits taxes by applying the Commissioner's special assessment ratios to the reduced net income.

The respondent's right to special assessments is predicated upon subdivision (d) of Section 327. (Nos. 476 and 477, R. 89.) That subdivision provides that profits taxes shall be determined by special assessment where, on application by a corporation, the Commissioner finds and declares that the tax if determined without benefit of special assessment would, owing to abnormal conditions affecting capital or income, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without the benefit of special assessment and the tax computed under Section 328 with reference to the average tax of representative corporations." Section 328 (a) provides that in cases specified in Section 327 the tax shall be the amount "which bears the same ratio to the *net income* of the taxpayer" as the "average tax of representative corporations engaged in a like or similar trade or business, bears to their average *net income*." (Italics ours.) Section 328 (a) further provides:

"The primary purpose underlying the enactment of these provisions was to afford relief in those exceptional cases where the normal method of determining profits taxes would result in grave hardships or serious inequality. See Sen. Rept. No. 617, 65th Cong., 3rd Sess., pp. 14–15.

> * * * the Commissioner shall compare the taxpayer only with representative corporations * * * which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

Section 328 (b) provides that "the ratios between the average tax and the average net income of representative corporations" shall be determined by the Commissioner in accordance with regulations prescribed by him. Article 911, Treasury Regulations 45 (1920 Edition), issued under the Revenue Act of 1918, pp. 37–38, *infra*, provides in part:

> The provisions of section 328 do not permit the determination of a general average for any trade or business. In each case which comes under the provisions of section 327 the Commissioner will determine, as nearly as may be, the group or class of corporations with which the corporation should be compared * * *.

The ratios used by the Commissioner in computing respondent's profits taxes for 1918 and 1919 by special assessment were found by comparison of respondent with representative corporations similarly situated "with respect to gross income, *net income, profits per unit of business transacted*

and capital employed, the amount and rate of war profits or excess profits, *and all other relevant facts and circumstances.*" (Italics ours.) The amount of the respondent's *net income* was necessarily, under the statute, a basic factor in the comparison of respondent with representative corporations. The alteration of respondent's net income, by the allowance of additional deductions of $520,733.33 for 1918 and $104,571.43 for 1919, changed not only the "net income" but also the "profits per unit of business transacted," the "amount * * * of war profits or excess profits," and the relation between capital employed and net income." It is, obviously, impossible to know whether the Commissioner would have used the same or even similar comparatives had he known that the respondent's net income for 1918 and 1919 was very substantially less than he then found it to be. What "other relevant facts and circumstances" went into his selection of comparatives does not appear. Indeed, the record contains no data as to the Commissioner's selection of comparatives. It can not be known whether the Commissioner's ratios of tax to income were the proper ones to be applied to respondent's reduced net income. More-

[1] An excellent idea of the inter-relation of "net income" with the considerations upon which both the right to special assessment (under Section 327 (d)), and the computation of the tax are determined is obtained from the "Comparative Statistics Data Sheet," Treasury Department Form No. 7885, Appendix B, p. 60, *infra*, used in special assessment cases.

over, it may well be that a reexamination of comparatives in view of the changed factors would show that the tax as computed without the benefit of special assessment was not disproportionate to that of representative corporations and consequently no need for special assessment."

Neither the granting of a new special assessment on respondent's revised net income nor the recomputation of the taxes could be made until performance of the preliminary tasks required of the Commissioner. The ratio of tax to income may not be fixed arbitrarily. To specific terms Section 328 (b) provides that "In any case, the actual ratio when ascertained shall be used in determining the correct amount of the tax." If the tax is properly to be computed under Sections 327 and 328 it must be determined in the manner required by the statute. "When a statute limits a thing to be done in a particular mode, it includes the negative of any other mode." *Botany Worsted Mills v. United States*, 278 U. S. 282, 289. The method of computation so provided has been confided to the Commissioner and the Board of Tax Appeals, but denied to the courts. In the instant cases the court below made no attempt to perform the preliminary tasks required by the statute but arbitrarily adopted special assessment ratios used by the Commissioner under quite different circum-

[10] Cf. Appeal of *Chalmers Publishing Co.*, 1 B. T. A. 929, where such a result was reached on review by the Board.

stances. The Circuit Court of Appeals, therefore, determined new profits taxes by a method lying outside the scope of its authority [17] and, moreover, made its computations without performing the duties which under the statue are a prerequisite thereto.

A substantially similar situation was presented in *Cleveland Automobile Co.* v. *United States* (N. D. Ohio), decided February 24, 1932, *supra.* There, as here, the taxes were determined by special assessment. After the taxes had been so computed the taxpayer claimed that they were excessive by reason of overvaluation of inventory by the Commissioner. There, as here, the taxpayer brought suit in the District Court to recover taxes alleged to have been illegally assessed. Although the court reached the conclusion that the Commissioner's valuation of the inventory was proper, it definitely considered the question of its authority to review the Commissioner's determination of the profits taxes, and held that it had none. The court said:

> If the net income of the taxpayer may be reduced upon consideration by the Court, the tax as determined by the Commissioner will cease to bear the same ratio to the net income of the taxpayer as the average tax of

[17] In *Oak Worsted Mills* v. *United States*, 38 F. (2d) 699, 704 (C. Cls.), Judge Littleton said in his concurring opinion: "To go into the question whether the Commissioner had authority to change his determination and reassess a portion of the tax refunded under the special assessment provisions would be the same as inquiring into the correctness of such determination."

> representative corporations engaged in a like or similar trade or business bears to their average net income for the years in question. In other words, should the Court determine that the Commissioner erroneously adopted an illegal method for valuation of the plaintiff's inventory, requiring a reduction in net income, it would not be proper, in my judgment, to apply the rate computed by the Commissioner.
>
> * * * * *
>
> To do so, it seems to me, would result in opening up the entire subject of tax computation and require the Court to review every factual element entering into the special assessment.

The chief fallacy in the argument of the respondent and in the decision of the Circuit Court of Appeals lies, we think, in the assumption that the ultimate function of the Commissioner under Sections 327 and 328 is to determine for the particular taxpayer a *rate of tax,* which, once determined, must be used for that taxpayer despite radical changes in the factors which were used in determining the rate. There is nothing in the language of the statute or the court decisions interpreting it which supports this view.[18] On the contrary, the

[18] In this respect the determination of profits taxes by special assessment differs radically from the ordinary method, in which the statute specifies a *rate* which is uniformly applicable to net income. See Revenue Act of 1918, §§ 210 (a) and (b), 211 (a), 230 (a) (1) and (2), 301 (a) and (b).

language of the statute shows plainly that the object sought and the duty placed upon the Commissioner is the *determination* and *computation* of the *tax*. Section 327 provides:

> That in the following cases the *tax shall be determined* as provided in section 328.

In Section 328 it is provided that:

> In the cases specified in section 327 *the tax* shall be the amount * * *.

In the second paragraph of Section 328 it is provided that:

> In *computing the tax* under this section the Commissioner shall compare the taxpayer only with representative corporations. * * *.

Subsection (c) of Section 328 provides:

> The Commissioner shall keep a record of all cases in which *the tax is determined* in the manner prescribed in subdivision (a) * * *. (Italics ours.)

Moreover, in the *Williamsport case* the Court made no mention of the determination of a *rate* of tax, but referred repeatedly to the "computation" of the tax, which, the Court said, was vested in the Commissioner "in all cases." (See pp. 13–14, *supra*.)

Clearly, the problem before the court below was not "the simple mathematical operation of applying the Commissioner's rates to the true income," as asserted by the respondent in its brief in op-

position (pp. 2, 6, 7). The use of the ratio of tax to income in special assessment cases is but an incidental, though necessary, operation in the computation of the tax, which is the end sought by the statute. Once determined, the ratio is not a factor which remains constant for a particular corporation, notwithstanding variations in the underlying factors upon which its determination is based. On the contrary, it remains correct only so long as these factors are not changed in such a manner as would effect a change of the comparatives. The discretionary acts which are removed from judicial review consist in the determination of the existence of "abnormal conditions" or of "exceptional hardship" evidenced by "gross disproportion" between the tax computed in the normal way and that computed by special assessment, the selection of "representative corporations" similarly situated, the determination of their "net income" excess profits, and like matters. These tasks are all directed to one end—the computation *of the tax*. Once performed, the determination of the ratio is a mere mathematical computation, easily made and involving in itself no exercise of discretion.

The respondent is quite inconsistent in arguing in its brief in opposition that the court below might redetermine the profits tax *qua* tax, although, as it concedes, the court had no power to change the determined ratio. This argument overlooks

the obvious fact that by applying the Commissioner's special assessment ratio to a revised net income the court was necessarily revising the ratio. It was the failure of the court below to appreciate that the tax ratio found by the Commissioner was relevant in the computation of the tax only so long as the underlying factors remained unchanged, which we think led to the erroneous conclusion that they might compute anew respondent's profits taxes by employing the "rates" used by the Commissioner.

The respondent in its brief in opposition (pp. 10–11) concedes that the special assessment ratios applied by the Circuit Court of Appeals to the reduced net income were not the *correct* ratios, but since, as it asserts, the correct rates must necessarily have been lower than the rates used by the court, the Government suffered no harm. Putting to one side the requirement of the statute that "In any case, the actual ratio when ascertained shall be used in determining the correct amount of the tax," the respondent's argument is fallacious because, as above pointed out, it can not be known (1) whether in the light of the reduced income respondent still is entitled to special assessment and (2) if so, that the rate of the tax must necessarily be lower.

In its brief in opposition (pp. 4, 11, 12) the respondent emphasizes its offer to prove at the trial that the abnormality upon which its special assess-

ments were based was an abnormality of *capital* and not of *income*—"for the purpose of establishing that any change in income could not remove the abnormality." The import of this suggestion is that the respondent would continue to remain entitled to special assessment no matter what reduction the court might make in its net income. The mere statement of this argument would seem clearly to illustrate its lack of foundation, since it completely overlooks the necessary correlation between capital and income in all determinations of the applicability of Section 327 (d). The test of applicability is not merely whether "abnormal conditions affecting the capital or income" exist, but whether such conditions create a gross disproportion between the tax computed in the normal manner and the average tax of representative corporations. Obviously, any substantial change in the net income, whether or not the capital remains unchanged, affects the applicability of Section 327 (d).

In its brief in opposition (pp. 10–11) the respondent argued that the statutory profits-tax rate is a graduated rate, that whenever the net income is decreased the tax rate also decreases, that since its net income was reduced its profits-tax rate should also have been reduced, but that since the *rate* can not be changed by the courts, the least the court below could do was to apply the erroneous, because too high, rates used by the Commissioner, and

this give the respondent at least a portion of the relief to which it was entitled. We think that what has been said above shows this argument also to be unfounded. It is true that when profits taxes are computed in the normal manner the tax rates are graduated as the statute requires; but when the taxes are computed by special assessment there is no "rate" other than the ratio of tax to net income of the comparatives selected. (Pp. 21–23, *supra*.) In Appendix C (p. 41, *infra*) we have set forth a computation showing how it might well happen that, by reason of the selection of comparatives having a higher ratio of tax, a taxpayer's profits tax would not necessarily be diminished by reason of a decrease in its net income.[19]

If the courts may in such a case as this redetermine profits taxes their power is necessarily limited to a redetermination of such taxes without special assessment, i. e., under Section 301 of the

[19] In the court below the respondent charged that a somewhat similar suggested computation was improper because it dealt with exaggerated and wholly supposititious circumstances. But it must be remembered that the special assessment provisions of the statute are applicable only in unusual cases, and if the relation of capital to income, as set out in the illustrated case (p. 41, *infra*), had been normal, special assessment would not have been allowed. Viewed in this light we think the suggested computation fairly reflects a possible situation and computation under the statute

statute.[20] Determination of profits taxes in the normal manner, under Section 301, involves the exercise of no discretionary administrative duties and represents the limit to which a court may go without invading the field left to the discretion of the Commissioner.

Congress may not have intended that a taxpayer should be compelled to pay a profits tax under Sections 327 and 328 in excess of that due under Section 301. But if a court, although without power to compute a taxpayer's profits taxes *by special assessment* as attempted in the instant cases, possesses the power to set aside the Commissioner's determination to the extent of reducing the tax to the amount due at normal excess profits rates without special assessment, there is no room or necessity for the operation of even this limited jurisdiction in the cases at bar. Although the Circuit Court of Appeals did not attempt to determine the amounts of profits taxes which would be payable by respondent on its reduced net income at normal excess profits rates, the respondent conceded in the court below that such taxes would be greater in

upon a reduction in net income. The Commissioner is required by the statute to select representative corporations. If such representative corporations show a higher tax ratio than that of corporations which would be representative if the taxpayer's net income were greater, it would not justify the Commissioner in refusing to apply the applicable ratio.

[20] Cf. the concurring opinion of Judge Littleton in *Oak Worsted Mills* v. *United States*, 38 F. (2d) 699, 704 (C. Cls.).

amount than the profits taxes as computed by the Commissioner.[21]

CONCLUSION

Whether the lack of judicial power to redetermine respondent's profits taxes will result in its being required to pay a larger amount of tax than it should pay is wholly problematical, and cannot be determined without the performance anew of the statutory functions of the Commissioner. Such functions are beyond the province of a court, and no provision is found in the statute whereby the instant cases may be referred to the Commissioner for redetermination of the profits taxes in light of the reduced net income. Assuming that this situation results in hardship to the respondent, the responsibility, if any, must be ascribed to the

[21] The Bureau of Internal Revenue has made a computation of the profits taxes which would be due from respondent under Section 301 upon the net income and invested capital as revised by the allowance of additional deductions in the Circuit Court of Appeals. This computation indicates that the profits taxes as so computed would be greater by $113,309.24 for 1918 and by $203,793.23 for 1919 than the taxes as computed by the Commissioner under special assessment. Attention is called to the fact that these figures are slightly different than the figures appearing in the computation referred to in footnote 4, page 11, of the petition for certiorari. We are advised by the Bureau that this earlier computation contained certain slight inaccuracies, and that as to each year it reflected the difference between the total taxes paid (income and profits taxes) and the amount of the income and profits taxes as then computed under section 301 upon the revised net income.

statute itself and respondent's choice to proceed under it. General principles of law should not be sacrificed in order to obtain what the court conceives to be justice in a particular case. The effect of a decision upon a particular taxpayer is an unsafe guide in determining legal principles of the kind here involved.

We submit that the judgment of the Circuit Court of Appeals, so far as it affects the Commissioner's determination of respondent's profits taxes, should be reversed.

Respectfully submitted.

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FEBRUARY, 1933.

APPENDIX A

STATUTES AND REGULATIONS

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1093:

SEC. 327. That in the following cases the tax shall be determined as provided in section 328:

(a) Where the Commissioner is unable to determine the invested capital as provided in section 326;

(b) In the case of a foreign corporation;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit

upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

SEC. 328. (a) In the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations pre-

scribed by him with the approval of the Secretary.

* * * * *

In any case, the actual ratio when ascertained shall be used in determining the correct amount of the tax. * * *

(c) The Commissioner shall keep a record of all cases in which the tax is determined in the manner prescribed in subdivision (a), containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, and the amount of invested capital as determined under such subdivision. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257.

Regulations 45 (1920 Edition), issued under the Revenue Act of 1918:

ART. 901. *Treatment of special cases.*—In the cases specified in section 327 of the statute the tax will be specially determined under the provisions of section 328, but the tax will not ordinarily be computed under section 328 merely because the corporation's form or manner of organization, or the limitations imposed by section 326, result in a greater tax than would otherwise be payable. A corporation which comes within the provisions of subdivision (d) of section 327 may make application for assessment under the provisions of section 328, which application shall be attached to its return in the form of a statement seting forth in full: (a) the reasons why the tax should be so determined;

(b) the facts upon which such reasons are based; (c) an exact description of each trade or business or important branch of a trade or business carried on by it; (d) a statement of the invested capital and net income for each year since the beginning of the prewar period; and (e) a statement showing the amount of gains, profits, commissions, or other income derived on a cost-plus basis from Government contracts made after April 5, 1917, and before November 12, 1918, and showing the per cent which such income is of the total income of the corporation. See sections 1 and 326 and articles 831–871 and 1510.

ART. 911. *Computation of tax in special cases.*—In the cases specified in section 327 of the statute the tax is to be computed by comparison with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are engaged in a like or similar trade or business and similarly circumstanced. The provisions of section 328 do not permit the determination of a general average for any trade or business. In each case which comes under the provisions of section 327 the Commissioner will determine, as nearly as may be, the group or class of corporations with which the corporation should be compared and the amount which bears the same ratio to the net income of the corporation (in excess of the specific exemption of $3,000) for the taxable year as the average tax of such representative corporations bears to their average net income (in excess of the specific exemption of $3,000) for such year. The comparison will take account of similarity with respect to gross income, net income, profit per unit of business transacted, and

capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

RULE 62.—SPECIAL ASSESSMENT

(*a*) If some of the issues raised by the petition involve section 327 or section 328 of the Revenue Act of 1918 or of 1921 [or section 210 of the Revenue Act of 1917, as the case may be], and some do not involve such sections, the hearing may, in the discretion of the Board, on motion, be limited in the first instance to trial of the issues which do not involve such sections.

(*b*) A hearing may, in the discretion of the Board, on motion, be had, limited to the trial of the issue whether the petitioner is entitled to have its tax determined as provided in section 328 [or section 210, as the case may be].

(*c*) If the Board decides that the petitioner is entitled to have its tax determined as provided in section 328 [or section 210, as the case may be], the respondent shall within 60 days after such decision file with the Board an original and two copies of a proposed redetermination showing the method of the computation. If, within 20 days after service by the Board upon the petitioner of a copy of such proposed redetermination, the parties are unable to agree upon the amount of tax, either party may move, or the Board may upon its own motion order, that the case be placed upon the day calendar for further hearing, at which either party may submit proof of the correct amount of tax and deficiency or overpayment.

(*d*) If from the pleadings or otherwise it appears of record before the Board that the parties agree that petitioner is entitled to have its tax determined as provided in section 328 [or section 210, as the case may be], and the only issue is as to the correct amount of the tax so determined, the case will be placed upon the day calendar in due course for hearing, at which either party may submit proof of the correct amount of the tax and deficiency or overpayment.

APPENDIX B

Income tax, audit review, special assessment

[Comparative statistics data sheet—Special cases—19..]

Comparative statistics re:.....Nature of business.....Case No.....

	Appellant	Comparative No. 1	Comparative No. 2	Comparative No. 3	Comparative No. 4	Comparative No. 5	Comparative No. 6	Average comparatives
Location								
Date of organization								
1. Invested capital as adjusted								
2. Statutory intangibles								
3. Adjustments for inadmissible assets								
4. Interest-bearing indebtedness								
5. Noninterest-bearing indebtedness to stockholders								
6. Gross sales								
7. Other income								
8. Cost of goods sold								
9. Ordinary and necessary expenses								
10. Compensation of officers								
11. Repairs								
12. Interest								
13. Taxes								
14. Bad debts								
15. Exhaustion, wear and tear (including obsolescence)								
16. Amortization of war facilities								
17. Depletion								
18. Special deductions from income								
19. Net income								
20. Percentage of net income to gross sales								
21. Percentage of net income to adjusted invested capital								
22. Percentage of cost of sales to gross sales								
23. Excess profits credit								
24. War profits credit								
25. Net income per unit of business								
26. Profits tax								
27. Percentage of profits tax to net income								
28. Net income previous year								
29. Average net income prewar period								
30. Average invested capital prewar period								
31. Percentage of net income to invested capital prewar period								

NOTE.—Enter on the data sheet for both the appellant and the comparatives only statutory figures.

Prepared by ..... Resident auditor.
Checked by ..... Date, ...
Reviewed by ..... Section auditor.

Final profits tax..... Appellant . $.....
Per cent of final tax to net income..... Appellant $.....
Constructed invested capital..... Appellant . $.....

APPENDIX C

Taxpayer company:	
Invested capital	$100,000
Net income	100,000
Statutory tax computed under Section 302	69,100
Comparatives before reduction in net income:	
Average invested capital	300,000
Average net income	100,000
Average statutory tax computed under Section 301	53,600

Tax on basis of the above comparatives is 53.6% of the net income.

If a reduction in net income of $17,000 be allowed then the situation is as follows:

Taxpayer company:	
Invested capital	$100,000
Net income	83,000
Statutory tax computed under Section 302	55,500

Upon a reexamination of the comparatives the Commissioner might find the following situation with respect thereto:

Comparatives after reduction of net income:	
Average invested capital	$120,000
Average net income	83,000
Average statutory tax computed under Section 301	54,400

Tax on the basis of the above comparatives is 65.5% of the net income.

In view of this situation it is entirely probable that the taxpayer would still be entitled to a special assessment, but that notwithstanding the decrease in income of $17,000 the tax computed on the basis of the new comparatives is greater than the tax computed on the basis of the former comparatives and prior to the reduction in income. The taxpayer thus would be liable for an additional tax notwithstanding the decrease in net income, both computations being made under Section 328.

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